Hotel Investment Strategies

Hotel Valuation Thumb Rule

The hotel industry has a rule of thumb that provides a rough approximation of a hotel's value based on its room rate. This thumb rule states: the value of a hotel can be estimated by multiplying the hotel's average room rate by 1,000. The result is the value of the hotel on a per room basis. Thus, if a 100-room hotel has an average room rate of US$95, then its value per room is US$95,000 (US$95 x 1,000 = US$95,000). The total value of the hotel would be US$950,000 (US$95,000 x 100 = US$950,000).

Obviously, many factors go into estimating a hotel's value, but over the years this rule of thumb has been surprisingly accurate. I use it each time I review an appraisal to see whether the final estimate of value makes sense. For example, if an appraisal of the property described above came in at a value of US$800,000 on the low side or US$1.1 million on the high side, I would review the appraisal analysis thoroughly to determine why there was a discrepancy between the actual appraisal and the thumb rule. In most instances the difference can be attributed to factors such an abnormally low or high occupancy, highly efficient or inefficient management, or unusual sources of other revenues. These differences often will skew the appraised value, making the rule of thumb approach inaccurate.

This rule of thumb also is helpful in evaluating the initial feasibility of a proposed hotel. Instead of comparing the results to market value, the rule of thumb can be used to determine whether the total project costs are in line and also how much can be paid to acquire the land.

In the above example, if the estimated total project cost was significantly more than US$950,000, the overall project feasibility would be in doubt. In addition, the land component should not be more than 20% of the total project's value. Thus, if the developer was going to pay much more than US$190,000 for the land (US$950,000 x 20% = US$190,000), it would probably not work from a financial perspective and adjustments to the pricing or deal structure would be necessary.

Let's look at how the hotel valuation thumb rule actually works. A hotel can be valued by dividing the projected net income by an appropriate capitalization rate. A capitalization rate is a factor that combines the cost of the debt and equity capital used to finance a hotel.

The left side of Table 1 shows an income and expense statement for a typical full-service hotel in the United States (data from Smith Travel Research). The data in the first column is the dollar amount per available room, and the data in the second column is the corresponding percentage of revenue. This typical hotel generates a net income of US$12,049 per room. If an appropriate capitalization rate is 11% then the value per room is US$110,000 (US$12,049/.11 = US$110,000). Using this hotel's average rate of US$128 and the hotel valuation thumb rule, this hotel should be worth US$128,000 per room, not US$110,000 per room. The problem is that the occupancy level (64.7%) for this typical hotel is too low for the thumb rule to work. I have, therefore, adjusted the occupancy upward until the net income is sufficient to create a value of US$128,000 per room when capitalized at 11% (right columns). For the rule of thumb to work at an 11% capitalization rate, the hotel's occupancy needs to be approximately 69%. A way to adjust for differing levels of occupancy is to use an Average Rate Multiplier adjuster. For the typical hotel, this adjuster is .860. So if you multiply the US$128 average rate by .860 you will get an adjusted average rate of US$110, which when used in the hotel valuation thumb rule will give the correct value.

Table 2 shows the Average Rate Multiplier adjuster for various levels of occupancies along with different mortgage interest rates. Since a large component of a capitalization rate is mortgage interest, I have chosen this factor as a basis for selecting the multiplier.

Here is an example of how to use this table: Assume your hotel is operating at an average room rate of US$100 and the occupancy is 75%. At the time of your valuation hotel mortgage interest rates are 8%. Using Table 2, the Average Rate Multiplier for this occupancy and mortgage interest rate is 1.197. The adjusted average rate would be US$100 x 1.197 = US$119.70, and the value would be US$119,700 per room.

TABLE 1

	National Average		Thumb Rule P&L	
Occupancy	64.7%		69.1%	
Average Rate	$128.00		$128.00	
	$/Avail Rm	**Percent**	**$/Avail Rm**	**Percent**
Total Revenue	$48,438	100.0%	$51,362	100.0%
Departmental Expenses	19,938	41.2	20,416	39.7
Departmental Income	28,500	58.8	30,946	60.3
Undistributed Operating Expenses	11,128	23.0	11,308	22.0
Income Before Fixed Charges	17,372	35.9	19,638	38.2
Fixed Charges	5,323	11.0	5,527	10.8
Net Income	12,049	24.9	14,111	27.5
Capitalization Rate	0.11		0.11	
Value Per Room	110,000		128,000	
Average Rate Multiplier	0.860		1.000	

TABLE 2
AVERAGE RATE MULTIPLIER

	Mortgage Interest Rate								
Occ.	**10.5%**	**10.0%**	**9.5%**	**9.0%**	**8.5%**	**8.0%**	**7.5%**	**7.0%**	**6.5%**
80%	1.210	1.238	1.267	1.298	1.330	1.364	1.399	1.437	1.476
75	1.062	1.087	1.113	1.140	1.168	1.197	1.229	1.262	1.296
70	0.915	0.936	0.958	0.981	1.006	1.031	1.058	1.086	1.116
65	0.767	0.785	0.804	0.823	0.843	0.865	0.887	0.911	0.936
60	0.620	0.634	0.649	0.665	0.681	0.699	0.717	0.736	0.757
55	0.473	0.483	0.495	0.507	0.519	0.533	0.547	0.561	0.577

Remember thumb rules are not always accurate but this one does provide a rough approximation of value. Using the Average Rate Multiplier adjustment that factors in both occupancy and mortgage interest further enhances its accuracy. ◆

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